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Symposium: Is the Maryland Director and Officer Liability Statute Based on a Male-Oriented Ethical Model?

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IS THE MARYLAND DIRECTOR AND OFFICER LIABILITY STATUTE BASED ON A MALE-ORIENTED ETHICAL MODEL?

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I. INTRODUCTION

The Maryland Director and Officer Liability Statute of 1988 permits corporate directors, officers, and stockholders to bargain among themselves to determine the extent of the limitation on the liability of officers and directors for their actions or inactions in the conduct of corporate business.[1] Management determines its obligations by contracting with shareholders in regard to the risks each party agrees to assume in the management of the corporation. Their responsibilities to each other are based primarily on the freedom each side has to contract or not to contract.

This statement of the purpose and structure of the Maryland statute is overly simplistic because the statute does prohibit the parties from limiting liability for a manager's receipt of "an improper benefit or profit in money, property, or services,"[2] or where "the person's action, or failure to act, was the result of active and deliberate dishonesty. . . ."[3] Absent in the new statute, however, is language which requires loyalty of the manager in the conduct of corporate affairs.[4]

Legal scholars have traditionally described the obligation between corporate managers and the entity they serve as a fiduciary duty. The legal model of the statute prior to the 1988 amendment was based pri-

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1. MD. CORPS. & ASS'NS CODE ANN. § 2-405.2(a) (Supp. 1988). Section 2-405.2 provides:

   > (a) *Effect of corporate charter.* — The charter of the corporation may include any provision expanding or limiting the liability of its directors and officers to the corporation or its stockholder for money damages but may not include any provision which restricts or limits the liability of its directors or officers to the corporation or its stockholders:
   >
   > (1) To the extent that it is proved that the person actually received an improper benefit or profit in money, property, or services . . . actually received;
   >
   > (2) To the extent that a judgment or other final adjudication adverse to the person is entered in a proceeding based on a finding in the proceeding that the person's action or failure to act, was the result of active and deliberate dishonesty and was material to the cause of action adjudicated in the proceeding.

2. *Id.* § 405.2(a)(1).
3. *Id.* § 405.2(a)(2).
4. Hanks, *Maryland Adopts Director and Officer Liability Statute*, 2 INSIGHTS, No. 3, Mar. 1988; *see also* Sargent, *Two Cheers For the Maryland Director and Officer Liability Statute*, 18 U. BALT. L. REV. 278, 295-302 (1989).

marily on trust law:[5] the manager, as a fiduciary or trustee, had the trust of the shareholders in exchange for his obligation of loyalty.[6] This model assumes an inherent obligation on behalf of the manager to act for the benefit of shareholders and to be primarily loyal to them.[7] The new statute, on the other hand, adopts a contractarian model,[8] leaving the obligations between managers and shareholders subject to allocation by contract. Yet, who can possibly accuse the drafters of the new statute with any wrongful intent, or indeed, as the title of this Article suggests, of sexism, when the drafters' intent seems only to maximize individual choice?

The short answer is that the drafters have essentially eliminated the common law duty of loyalty from the new statute by elevating the place of bargaining to determine the obligation of management to shareholders. This shift in models will have a negative impact on the relationship between managers and investors in Maryland corporations. Both the drafters' preference for a contract model,[9] and their lack of concern for the affect of the contract model on the relationship between management and shareholders, are the bases for the argument that the Maryland Director and Officer Statute of 1988 is male-oriented.[10]

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5. MD. CORPS. & ASS'NS CODE ANN. § 2-405.1(a) (1985); *see also* Maryland Metals v. Metzner, 282 Md. 31, 382 A.2d 564 (1978); Chesapeake Contr. Corp. v. Rodman, 256 Md. 531, 261 A.2d 156 (1970); Indurated Concrete Corp. v. Abbott, 195 Md. 496, 74 A.2d 17 (1950).
6. Frankel, *Fiduciary Law*, 71 CALIF. L. REV. 795, 800 (1983). The connection between the duty of loyalty and the trust theory arises because the trustee is held to a fiduciary duty of loyalty. Corporate law adopted the trust analogy early on and courts announced that directors in corporations also would owe a duty of loyalty to the corporation. 1 W. FLETCHER, CYCLOPEDIA OF THE LAW OF PRIVATE CORPORATIONS § 1 (rev. perm. ed. 1983).
7. Brudney, *Corporate Governance, Agency Costs, and the Rhetoric of Contract*, 85 COLUM. L. REV. 1403, 1407 n.15 (1985). Brudney notes:

   > [H]e expects [under the fiduciary model] and is entitled to have the trustee exercise its best efforts solely to serve the (settlor's) beneficiary's welfare and to refrain from using trust property for any purpose other than one in the (settlor's) beneficiary's exclusive interest.

   Id. Brudney argues further:

   > Neither the more "paternalistic" vision nor the "relational contract" concept of contract law embraces the protective stance of the fiduciary strictures which inform agency law.

   Id. at 1407.
8. *See generally* Fama, *Agency Problems and the Theory of the Firm*, 88 J. POL. ECON. 288, 290-93, 295 (1980); Jensen & Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305, 308-11 (1976); *cf.* D. BAYNE, THE PHILOSOPHY OF CORPORATE CONTROL, A TREATISE ON THE LAW OF FIDUCIARY DUTY (1986) (Bayne assumes that the fiduciary model is the starting point of corporate governance).
9. *See* Butler & Ribstein, *Free at Last? The Contractual Theory of the Corporation and the New Maryland Officer-Director Liability Provisions*, 18 U. BALT. L. REV. 352, 353-60 (1989).
10. This article will not fully develop a philosophical analysis of the differences between the male and female-oriented ethical models. Ethicist Annette Baier has done that elsewhere. *See* Baier, *What Women Want in a Moral Theory?*, 19 NOUS 53-64

II. THE CONTRACT MODEL IN ETHICS

To understand the significance of this shift in models of decision making and its negative impact on the relationship between managers and shareholders, an examination of the debate concerning the most appropriate ethical model for obligations between parties is instructive.[11]

The ethicist Annette Baier argues that there are competing models in ethics which she labels "contractarian" and "trust" models. To understand Baier's use of these labels, it is necessary to examine her assumptions in defining a "trust" model as distinguished from a "contractarian" model.

The trust model is based on the proposition that human relationships thrive only in an atmosphere of trust—a relationship best exemplified by that of parent and child—where the parent is trusted by the child to care for it.[12] The focus in the trust model is on the potential growth of the relationship and the distribution of risks as they arise. Entrustors[13] assume certain risks in the hope that a greater benefit will result from the relationship.[14]

(1985). Instead, the author assumes that differences in these ethical models do in fact exist.

11. *See* Baier, *Trust and Antitrust*, 96 ETHICS 231 (1986). Whenever there are shifts in the underlying models of legal obligations, the legal profession needs to be aware that ethicists (those philosophers who pay particular attention to the bases or models of "oughts" between individuals in society) have special insights into the consequences of such shifts in models of obligations. The ethicist's study of the cohesion, pattern, or model for making decisions that concern others is similar if not foundational to the lawyer's study of the cohesion, patterns, and models that guide judicial decisions. Ethical models are instructive in understanding the consequences of the decision making models statutes adopt to guide behavior. At least one legal scholar has seen the import of analyzing the ethical models of obligations as they relate to tax law. *See* Kornhauser, *The Rhetoric of the Anti-Progressive Income Tax Movement: A Typical Male Reaction*, 86 MICH. L. REV. 465 (1987).

12. To Baier, there is no sense in which the child contracts with its parent to distribute risks between them. The parents are simply trusted to care for the child, and without trust the relationship will not thrive. Baier, *supra* note 11, at 241.

13. *See* Frankel, *Fiduciary Law*, *supra* note 6, at 800 (1983). The author uses the entrustor as Professor Frankel does. Frankel writes:

> 'Entrustor' appears to be most descriptive because it connotes both aspects of what this Article defines as the unifying features of fiduciary relations. The first feature, the 'substitution function,' in which the fiduciary performs services as a 'stand in' for the entrustor, is suggested by the root "trust" . . . . The second feature, the 'delegation of power,' in which the fiduciary granted the power to perform these functions, is suggested by the word 'entrust,' which means '[t]o confide . . . the execution of (a task) to . . . a person.' 3 OXFORD ENGLISH DICTIONARY (pt. 2) 225 (J. Murray ed. 1897).

Id. n.18.

14. Baier, *supra* note 11, at 251. Baier states:

> Contracts distribute and redistribute risk so as to minimize it for both parties, but trusting those more powerful persons who purport to love one increases one's risks while increasing the good one can hope to secure. Trust in fellow contractors is a limit [sic] case of trust, in which fewer risks are taken, for the sake of lesser goods.

The contractarian model, however, depends upon the existence of explicit promises as the basis for the relationship and attempts to prospectively distribute all risks among the parties. The contractarian model rejects the principle that trust is essential to a thriving relationship and instead promotes self-interested, adversarial bargaining to establish the obligations of the parties.[15] The contracting parties consider their own security and have no general obligation to take care of the other.[16] To bargain successfully, the parties must anticipate all risks that may arise from the relationship. In most long-term relationships, however, anticipation of all risks is very difficult if not impossible.[17]

Baier's argument that the contractarian model is male-oriented is based on the work of psychologist Carol Gilligan, who maintains that males and females have different preferences for ways of making decisions.[18] Baier argues that womens' heightened concerns for relationships affect their ethical models for decision making:

> Women cannot now, any more than they could when oppressed, ignore that part of morality and those forms of trust which cannot easily be forced into the liberal and particularly the contractarian mold. Men may but women cannot see morality as essentially a matter of keeping to the minimal traffic rules, designed to restrict close encounters between autonomous persons to self-chosen ones. Such a conception presupposes both an equality of power and a natural separateness from others, which is alien to women's experience of life and morality. For those most of whose daily dealings are with the less powerful or the more powerful, a moral code designed for those equal in power will be at best nonfunctional, at worst an offensive pretense of equality as a substitute for its actuality.[19]

Id.

15. *Id.* at 257; *see also* Frankel, *supra* note 6, at 799.
16. Frankel, *supra* note 6, at 800.
17. Baier, *supra* note 11, at 250.

> Contract enables us to make explicit just what we count on another person to do, in return for . . . what damages can be extracted from them. The beauty of promise and contract is its explicitness. But we can only make explicit provisions for such contigencies as we imagine arising.

Id.

18. *Id.* at 249. These preferences are derived primarily from early childhood experiences in which girls identify more closely with their primary care provider, the mother. Boys, on the other hand, are less concerned with relationships because they are essentially different than their mothers, and as they come to understand their differences with the primary care providers, they become more concerned with independence and power and less concerned with relationships. *See also* C. GILLIGAN, IN A DIFFERENT VOICE (1982).
19. Baier, *supra* note 11, at 249. Professor Baier also argues that the contractarian model of ethics is male-oriented because of the individual characteristics of the male proponents of philosophical-ethical contract models that cause them to fixate on the contract model. She argues that males more typically misunderstand the need for the nature of trust in relationships. She writes:

> The great moral theorists in our tradition not only are all men, they are

Of course it is not at all clear, as Baier suggests, that women have a corner on feelings of concern that certain laws might have an adverse effect on relationships between parties of unequal bargaining power. Ironically, the law of corporations has been governed during earlier, more sexist times, by the fiduciary concepts of trust. Perhaps then advocates of contractarian models are simply responding to the rise of equality between the sexes. Yet Baier's point is nonetheless valid, that the rise of the contractarian models has given way to a false, but universal, assumption of equality which has obscured the need to treat some groups with more care than others. In describing the differences in the trust and contract models, Baier discovers a basis of critiquing the over-inclusive assumptions found in contractarian models of ethics.

Baier further argues that modern contractarian philosophy is male-oriented both because of who frames the issue (mostly males)[20] and what examples have been used to prove the contractarian model.[21] Contractarians concentrate on the morality of "fairly cool" relationships between those who are roughly equal in power.[22] Although Baier recognizes that the contractarian model's exchange of promises involves trust,[23] she argues that promises are not a prerequisite for trust, and in

> mostly men who had minimal adult dealings with (and so were then minimally influenced by) women. With a few significant exceptions (Hume, Hegel, J.S. Mill, Sidgwick, maybe Bradley) they are a collection of gays, clerics, misogynists, and puritan bachelors. It should not surprise us, then, that particularly in the modern period they managed to relegate to the mental background the web of trust tying most moral agents to one another, and to focus their philosophical attention so single-mindedly on cool, distanced relations between more or less free and equal adult strangers, say, the members of an all male club, with membership rules and rules for dealing with rule breakers and where the form of cooperation was restricted to ensuring that each member could read his *Times* in peace and have no one step on his gouty toes. Explicitly assumed or recognized obligations toward others with the same obligations and the same power to see justice done to rule breakers then are seen as the moral norm.

Id. at 247-48.

20. *Id.*

21. "Male-oriented" thinking explains why the typical ethical philosopher draws dilemmas from analyses of relations between governments. *Id.* at 249-50. Although between governments the contractarian model has some functional attributes, this model breaks down in the simplest of situations, for instance, when a citizen interacts with the government. *Id.* at 250.

The choice of the subject of ethical study affects the choice of the ethical model. If an ethicist focuses on the publicly held corporation rather than the closely held company, the model developed is less appropriate for the closely held company, just as the focus on ethics between nations obscures the nature of the ethics between a government and its citizens.

22. *Id.*

23. Baier, *supra* note 11, at 245.

> In his famous account of what a promise (and a contract) involves, Hume strongly implies that it is an artificially contrived and secured case of mutual trust. The penalty to which a promisor subjects himself in promising, he says, is that of 'never being trusted again in case of failure.' The problem which the artifice of promise solves is a general disadvantageous 'want

fact an exchange of promises may inhibit trust.[24] Contracts are designed for

> [c]ooperation between mutually suspicious risk adverse strangers, and the vulnerability they involve is at the other extreme from that incurred by trusting infants. Contracts distribute and redistribute risk so as to minimize it for both parties, but trusting those more powerful persons who purport to love one increases one's risks while increasing the good one can hope to secure. Trust in fellow contractors is a limit [sic] case of trust, in which fewer risks are taken, for the sake of lesser goods.[25]

Regardless of whether the contractarian model is male-oriented, other significant differences between the contractarian and trust models become clear. The contractarian and trust models in ethics differ in how each deals with harms and opportunities that arise over the course of the relationship. The contractarian model provides that when the contract does not cover a certain risk, the actor's behavior will be judged (as long as the actor did not act criminally) on the basis of the obligation that would have been contracted for had the parties foreseen this risk.[26]

In comparison, the trust model assumes that the manager owes more to the entrustor than to self. If something goes wrong, the manager's first obligation is to protect the entrustor's interest even at the expense of his own job. The same is true with opportunities. If new opportunity presents itself, the trust model confers ownership of the opportunity to the entrustor. The question of manager compensation is an afterthought.

In addition, when using the contractarian model to judge a particular situation, there is a tendency to infer that the parties were aware of the risk at the beginning of their relationship.[27] It becomes much easier

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> of mutual confidence and security.' It is plausible to construe the offer whose acceptance counts as acceptance of a contract or a promise as at least implicitly including an invitation to trust.

Id. (quoting D. HUME, TREATISE 521-22 (1978)).

24. *Id.* at 251.

25. *Id.*

26. L. SOLOMON, D. SCHWARTZ & J. BAUMAN, CORPORATIONS LAW AND POLICY 334, 335 (2d ed. 1988) [hereinafter L. SOLOMON]. When developing the hypothetical obligational contract the parties would have created to cover risks, the contract model assumes the transactional costs to bargain over the risk to be zero. *Id.* If one party bears a greater economic burden for the bargain, the contract model will readjust the burden of risk in favor of that party. *Id.*

27. *See* Kennedy, *Distributive and Paternalist Motives in Contract and Tort Law, With Special Reference to Compulsory Terms and Unequal Bargaining Power*, 41 MD. L. REV. 563, 578-585 (1982).

Kennedy argues that it is possible for a decision maker to construe gaps and ambiguities in contracts from a distributive and/or paternalistic perspective. Most often, however, the motive of efficiency seems to be paramount.

> Efficiency motives differ from paternalist motives because their premise is that the affected parties will prefer the new situation to the old, so they would not choose to "waive" the benefits the decision maker has at-

to rationalize therefore that because the harmed party did not bargain for protection in the first place, they assumed the risk of injury.[28] And because some benefit likely inured for assuming the risk, it is "fair" that the harm lies where it falls.[29] Again, this model presumes that each party has equal bargaining power and equal choice to enter or exit the relationship, which in many cases is an incorrect assumption.

The contractarian model therefore may have an unhealthy side effect: it may cause the parties to fear that each will bear the burden of losses because each cannot possibly anticipate all risks that will arise and contract knowledgeably about them.[30] This fear will create distrust between the parties which may either destroy the relationship entirely or make it less beneficial to each.[31] The bargaining process informs each party how they can be hurt and assumes that each will be free to injure the other absent a protective provision in the contract to the contrary.

III. RELATIONSHIPS BETWEEN MANAGERS AND SHAREHOLDERS

How do these criticisms of the contractarian model in ethics apply to the relationships between managers and shareholders in a corporation? If a trust model is more appropriate for the parent-child relationship,[32] and the contractarian model is more appropriate for "mutually suspicious risk adverse strangers,"[33] then why does it not follow that the contractarian model is better for the corporation?

The corporate relationship, epitomized by management's control of information and the day-to-day conduct of the parties, is strikingly similar to the relationship between parent and child. The passive investor

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> tempted to confer on them. The decision maker is not trying to decide what is "really" best for them, without regard to their own views on the matter. On the other hand, an intervention grounded in efficiency concerns will always involve speculation about what the parties "would have done" had they not been prevented by transaction costs.
>
> . . . .
>
> We might distinguish between efficiency and distributive motives on the ground that the first involve making both parties better off, while the second involve helping one at the expense of the other. However, I want to fudge this distinction, and treat as motivated by efficiency some interventions that have negative effects on some actors. In particular, I will treat as motivated by efficiency the following type of action: the decision maker imposes a term in a contract in the belief that if the parties had full information almost all sellers would offer it at a price that almost all buyers would accept. In this case, there are some negative distributive impacts, on those who wouldn't have offered the term and on those who wouldn't have paid for it had we not changed the rule to make them do so.

Id. at 573-74.

28. *Id.*
29. *Id.*
30. Baier, *supra* note 11, at 257-58.
31. *Id.*
32. *See supra* note 12 and accompanying text.
33. *See* text accompanying note 25 *supra*.

depends on the manager like a child depends on the parents' knowledge and skill. Although shareholders' dependence is not as broad and pervasive, they nonetheless rely on the expertise of the corporate managers.[34]

Baier's criticism of the contractarian model is particularly applicable to Maryland's new statute in the sense that, although the statute deals with a complex, continuous relationship where the fundamental model for making decisions implicitly requires that the manager be loyal to subordinate shareholders, the scheme of the new statute disregards the need for loyalty in this arguably unbalanced corporate relationship. The statute's disregard for the subordinate position of shareholders is best illustrated by its burden of proof requirements.

Prior to its amendment in 1988, the statute adopted a trust model approach, allowing shareholders to prove the existence of a conflict of interest merely by showing that they were not fully informed of corporate affairs and that the manager personally benefited from the disputed transaction.[35] The manager could escape liability only if he could prove that he acted fairly.[36] Thus, the prior statute protected the entrusting shareholders by placing the ultimate burden of proving the fairness of a manager's transaction on the manager himself.

The new statute, on the other hand, provides that the risk of loss be borne by shareholders unless they prove that the manager's taking was

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34. *See* Brudney, *supra* note 7, at 1404, where the author states:

> But the contract concept has serious defects for at least one of the significant purposes for which it is offered — as a description of the relationship between investors, particularly stockholders, in publicly owned corporations and managers. In that context, the rhetoric of contract proceeds on doubtful assumptions about the circumstances of the parties, imports inappropriate normative consequences to govern the relationships thus assumed, and serves the ideological function of legitimating substantially unaccountable managerial discretion to determine corporate activities and to serve itself at the expense of investors.

Id.

35. *See supra* note 5.

36. L. SOLOMON *supra* note 26, at 714 (2d ed. 1988); *see also* Brudney, *supra* note 7, at 1407; *cf.* REVISED MODEL BUSINESS CORP. ACT § 8.31 (1984) (which does not indicate explicitly who has the burden of proving fairness, once a conflict is established).

Baier's argument about the failing of contract language in moral philosophy is reminiscent of the debate concerning the meaning of the words "good faith" found in the implied covenant of good faith and fair dealing that contract law declares part of contracts for the sale of goods. Brudney argues that the analysis of whether conduct is improper, or in bad faith, under a contract is different from analysis of whether a person has acted loyally. If not, how is the contract relationship different from relationships based on status, or fiduciary principles? *Id.* at 1404-05; *cf.* Kennedy, *supra* note 27, at 573. Kennedy argues that gaps in contract law, filled by the decision maker according to the criteria of what the parties would have decided had they been able to contract with zero transaction cost, is a meaningless standard that *is capable* of being manipulated paternalistically to serve relational purposes. Kennedy notes that it is unlikely to be used this way because of the values those who use this standard are likely to have — values of individual responsibility on the part of the entrustor to protect himself from harm. *Id.* at 598.

improper.[37] Moreover, the new statute includes no duty of loyalty and insulates a manager who acts in "good faith" from suit by the corporation or stockholders. Arguably, therefore, under the new statutory scheme, the burden of proving the unfairness of a manager's transaction never shifts to the manager; instead the burden remains with the shareholder to prove that the manager treated shareholders unfairly. This shifting of the burden of proof to shareholders is unrealistic in light of their limited access to transactional information and their lack of involvement in the day-to-day operation of the corporation. Even if shareholders were to have unlimited ability to access such information, the evidence of managerial misconduct that shareholders present may be insufficient because of the equivocal meaning of "good faith" as it is used in the new statute.[38]

The General Assembly's replacement of the duty of loyalty with the concept of good faith will make it increasingly difficult for courts faced with the task of defining good faith to include in their definition the notion of a selfless fiduciary.[39] Instead, courts will be presented with the argument that the "selflessness" implied in the concept of loyalty to shareholders has been rejected by the Maryland legislature.

By releasing the manager from a duty of loyalty, "good faith" will become a question of interpretation for the courts, an interpretation that will likely divert their attention to maxims of documentary or statutory interpretation. This diversion will inevitably lead the finder of fact to hopelessly contradictory assumptions about the meaning and purpose of the statutory language.[40] No longer will altruism and selfless concern be the standard against which good faith is to be measured. Instead, the court's analysis will center on a comparison between the manager's allegedly improper behavior and the behavior expected of a manager motivated by self-interest, but who acts in "good faith" nonetheless.

The contractarian model adopted by the new statute looks backward to the old model of nineteenth century laissez-faire individualism, where society works best when individuals are unhampered by government regulation.[41] Under this scheme, courts are less likely to ask whether the relationship between management and shareholders would be better served if managers got specific permission from shareholders before acting in self-interest. Rather, the court will substitute its judgment that the corporation would permit its managers to expend corporate funds for personal benefit because, if the corporation was opposed to those expend-

37. This shifting of the burden of proof shows up in the indemnification portion of the Maryland statute. It provides that the officer or director will be indemnified by the corporation unless it is proved by a contesting party that the individual acted in bad faith. MD. CORPS. & ASS'NS CODE ANN. § 2.418(b) (Supp. 1988); *see also* MD. CORPS. & ASS'NS CODE ANN. § 2-405.2(a) (Supp. 1988).
38. MD. CORPS. & ASS'NS CODE ANN. § 2.418 (Supp. 1988).
39. Kennedy, *supra* note 27, at 580.
40. *Id.* at 599-604.
41. L. FRIEDMAN, CONTRACT LAW IN AMERICA 20-24 (1965).

itures, it could have contracted against them.[42]

In the great majority of cases, the loss would fall on the shareholders unless they anticipated the particular risk and contracted for protection. Therefore, shareholders either need to become educated about such risks or to pay someone else to protect them against the various and sundry ways managers may take advantage of their status in the corporation.[43] Some legal commentators contend, however, that such an awareness on the part of shareholders will seldom if ever exist.[44] Under the model of the new statute then, the shareholder will be left largely unprotected. Using Baier's analogy, they are left in a position like that of children without parents to protect them.

IV. PUBLICLY HELD CORPORATIONS

It is necessary to distinguish between large, publicly held corporations and closely held companies. Arguably, Baier's criticism of the contractarian model suggests that such a model may be appropriate for the widely traded national stock exchange company, where bargaining takes place through market efficiency.[45] Because the widely traded company allows for easy transferability of ownership, and managers are deterred from unreasonable conflicts of interest by the close scrutiny of market analysts and major institutional stockholders, it is reasonable to say that a bargain has been implicitly struck over the bearing of risks. Additionally, the contractarian model is appropriate because of the equality of bargaining power and access to information among larger shareholders,

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42. Kennedy, *supra* note 27, at 599-604. There is also the real possibility that courts will take an even more extreme position in favor of protecting managers. Most judges (perhaps because of their lawyering experiences) are particularly adept at finding ambiguity in the language of the contract. And obviously there will be occasions when the corporate contract will not even remotely cover the conduct involved. Some judges might analogize that good faith means what it means to the lawyer bringing a lawsuit under a statute, *i.e.*, that where there is a way that the statute can be read that justifies the law suit, the attorney is acting in good faith. Similarly, where there is a way the manager's contract can be interpreted that justifies the manager's behavior, the manager's behavior is in good faith. The focus is on a good faith interpretation of a supposedly neutral document which in most instances has in fact been drafted by one of the parties, the one with the greatest advantage.

43. *See* Honabach, *Consent, Exit, and the Contract Model of the Corporation — A Commentary on Maryland's New Director and Officer Liability Limiting and Indemnification Legislation*, 18 U. BALT. L. REV. 310, 320-21 (1989). Honabach argues that at least with respect to new corporations, this open ended protection that matches loyalty protection will be priced out of existence.

44. *See* M.A. EISENBERG, THE STRUCTURE OF THE CORPORATION 68 (1976); Harris, *The Model Business Corporation Act — Invitation to Irresponsibility?*, 50 NW. U.L. REV. 1, 9 (1955). Professor Eisenberg argues that "in the publicly held corporation true shareholder agreement is all but impossible. [S]tockholders . . . [in such corporations] do not know of the provisions of the articles of incorporation, and, generally, if they did, they would not realize what the consequences of such provisions might be until it is too late." M.A. EISENBERG, *supra* at 68.

45. *See, e.g.*, Honabach, *supra* note 43, at 325-31.

despite the inequality in the bargaining power of any single shareholder.[46]

This argument, however, ignores the realities of publicly held corporations. As Professor Eisenberg demonstrates, the need to check managerial self-interest and inefficiency remains as great in a publicly held situation as in a closely held setting.[47] Because managers in a publicly held company are delegated the responsibility for all business decisions, as the volume of decisions grows and the choices become more complex, the number of conflicts will multiply. The ability of the market analyst and the institutional manager to know about the propriety of these transactions remains in doubt, and without adequate information, the market cannot act efficiently. The fact that a manager is acting as the agent of a large corporation does not diminish the manager's incentive to take advantage of his position in the company by covering up crucial information and by hoisting all adverse risks onto shareholders.[48]

V. THE CLOSELY HELD COMPANY

As inappropriate as the contractarian model may be for the publicly traded company, the new statute is at least equally inappropriate in the context of closely held companies. Because there is no secondary market for the shares, there is uncertainty in the value of the shares.[49] Thus, it is difficult for a seller to find a buyer willing to purchase what is unknown. Because of the inapplicability of the federal reporting statutes[50] to closely held businesses, it is much more difficult to monitor managers. The record keeping and minute taking habits of the closely held business are often more sloppy; shareholder meetings occur with less frequency and less formality; and there is no group of market analysts keeping watch over stock movements. There is also a zero sum game in closely held corporations between the dividend policy and salary distribution. This causes greater conflict between shareholders and managers, usually over fewer dollars.[51]

There is also a difference in the emotional aspects of the relationship between the parties. This difference is at the heart of Baier's critique as it applies to the corporate setting. In closely held corporations, family members often rely on other family members to exercise their judgment

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46. Easterbrook & Fischel, *Close Corporations and Agency Costs*, 38 STAN. L. REV. 271, 271-79 (1986).
47. M.A. EISENBERG, *supra* note 44; Brudney, *supra* note 7, at 1405.
48. Brudney, *supra* note 7, at 1405 n.5. Note also that if a contract will be the basis of obligations between shareholders and the corporation, the distinction between debt and equity will also be further blurred. If shareholders can contract over their rights to participate in corporate management, they may lose their status as shareholders and their protection of limited liability.
49. Easterbrook & Fischel, *supra* note 46; *see also* Honabach, *supra* note 43, 325-31.
50. 15 U.S.C. §§ 78a-jj (1982); Securites and Exchange Act, 1934, §§ 12-14.
51. Easterbrook & Fischel, *supra* note 46.

in favor of the entire family.[52] Closely held corporations often grow out of an expansion in a family business that was once a partnership.[53] Since the parties were accustomed to the fiduciary model of a partnership, they may expect that model to continue to govern the relationship even when the entity is incorporated. When the initial partners retire or leave the business, the family members of those partners depend on the judgment of the new managers to continue to work together and treat each member of the clan fairly. Not only do family members depend on the managers to keep the business healthy and family tradition intact, they also rely on the managers to keep the bond of the family unit strong. This heavy reliance by family members on family managers will cause a more volatile and emotional reaction by shareholders to managerial misconduct.[54]

Applying Baier's criticisms of the contractarian model in ethics, it becomes clear that the application of the contract model to the closely held corporate setting will have an adverse affect on the relationships of the parties. The absence of manager loyalty and selflessness will drive the parties as business partners and family members apart. The contract gives the manager an extra excuse to act selfishly. Those who complain would have to face their own "failure" or lack of foresight to explicitly protect themselves. The shift away from the duty of loyalty language and the shift in the burden of proving improper benefit will have the intended effect of diminishing shareholder challenges to manager actions.

The contractarian argues at this point, so what?[55] These costs are simply the costs of an investment in a closely held corporation.[56] If the costs are too great or the return insufficient, investors can first seek dissolution and then seek other forms of investment.[57] Yet this seemingly simple solution ignores both the difficulty of proving illegality of behavior under dissolution statutes and the historical trap in which many shareholders find themselves.[58] Shareholders in a closely held corporation cannot easily transfer in and out of the relationship because there is no market for their shares. It is therefore difficult for anyone to know what is going on, much less to second-guess a director's decision concerning the value of what the business is worth. While under either the trust or the contractarian model such second-guessing is left to the courts, under the trust model the manager has the burden of proving that the transaction in question was fair. Under the scheme of the new Maryland statute, the shifting of the burden of proof to the shareholder to

52. *See, e.g.*, Ringling v. Ringling Bros.-Barnum & Bailey Combined Shows, Inc., 29 Del. Ch. 318, 49 A.2d 603 (1946), *modified*, Ringling Bros.-Barnum & Bailey Combined Shows, Inc., 29 Del. 610, 53 A.2d 441 (1947).

53. L. SOLOMON, *supra* note 26, at 342.

54. *See, e.g.*, *Ringling Bros.*, 29 Del. Ch. 318, 49 A.2d 603 (1946).

55. Easterbrook & Fischel, *supra* note 46.

56. *Id.*

57. *Id.*

58. Hetherington, *Special Characteristics, Problems, and Needs of the Close Corporation*, 1969 ILL. L.F. 1, 10-25.

prove improper personal benefit is therefore a crucial element to be satisfied before a shareholder can be successful in challenging management. The shift in models may leave shareholders unprotected from acts of disloyalty.

Finally, will selecting a contractarian model in the closely held corporate setting restrict the potential for even greater returns for both parties should they operate in a relationship based on trust? What Baier's argument questions is the capitalistic assumption that selfishly motivated decisions of the manager will necessarily redound to the benefit of the entity.[59] Perhaps instead, encouraging the selfish interest of managers will distract managers from the "business of business" to the detriment of both shareholders and managers.

VI. IS THE MARYLAND STATUTE SEXIST?

The new Maryland statute permits managers to contract for releases from the traditional duty of loyalty as long as shareholders "agree." And shareholders are particularly likely to agree to management's suggestions if the shareholders have not shifted their model of the relationship the way the Maryland statute presumes that they will. Shareholders are unlikely to understand the trade-off inherent in the release of managers from loyalty constraints and to contract adequately for their future protection. Even if the shareholders understand the implications of the change in corporate models for the corporation and bargain for protection, the adversarial atmosphere created by such negotiations will cause managers to take advantage of opportunities to seize assets for themselves, as long as they are not explicitly prohibited from doing so by the contract. After all, under the new statute they are freed from their loyalty to others, and now need only look out for themselves.[60]

Baier's ethical argument is persuasive that the statute is a natural result of an incomplete ethical model.[61] The Maryland statute focuses on

59. Kennedy, *supra* note 27, at 578-85.

60. Of course it can be argued that if family considerations do not already raise the ethical obligations to treat family stockholders fairly, then corporate models would not make any difference. Yet before the Maryland statute the legal corporate and family "oughts" were similar. If the contract model works like it is supposed to, the corporate contract model will encourage managers to justify their behavior by imagining that their obligations to their family members as family members can be divorced from their obligations to these same individuals as shareholders. The contract model assumes self interested bargaining will and must take place in order that the risks be fully explored and fairly distributed. If a manager understands that his ethical obligations towards an in-law or cousin who owns shares arise from a contract as opposed to a model of trust derived from the manager's status in the family, the manager will likely act more adversarially and more from a perspective of self interest.

61. Baier's point, however, is not that ethical models ought to favor or even balance the rights of men and women; instead she suggests that these models should be used to improve relationships generally for everyone. Of course Baier may be unduly "feminist" in orientation and therefore does not recognize that many males have been very vocal against the use of the contractarian model in law. Perhaps she should be

the fairly cool relationship between hypothetical shareholders and managers who stand in equal bargaining power, have equal knowledge and skill, and are mutually suspicious and risk adverse. Under Baier's analysis the statute makes male-oriented assumptions about parties to the relationship. The drafters ignored the statute's affect on the passive investor who has little business expertise, and on the closely held family corporation, where there is relatively unequal bargaining power among the parties.

Relationships in which parties are without information and economic leverage will be more distrustful and aggressively hostile where the ethical model for the relationship is contractarian rather than one based on trust. Baier argues that a contractarian model produces harmful side effects in some relationships, but that men typically miss these side effects because they typically care less whether people get along.[62]

When the Maryland statute rejects the duty of loyalty provisions in favor of enabling contract provisions it is not sexist, but is mistakenly male-oriented because it overlooks the effect it will have on the relationships between managers and shareholders. The statute is incomplete because it is less concerned about healthy relationships and more concerned about power.

In order to evaluate Baier's argument in the corporate context, it is important to note that contract models are replacing trust models. Contractarians would certainly argue that the problems with trust models of corporate behavior have been fully understood and explored, and that

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forgiven for her oversight because she is not joining her debate with the legal profession. Yet the legal critics of the contract model are drawing on political philosophy to support their critiques. *See*, G. GILMORE, THE DEATH OF CONTRACT 94 (1974). Gilmore writes:

> We started with Professor Friedman's suggestion that the "model" of classical contract theory bore a close resemblance to the "model" of what he calls "liberal" — or I suppose, laissez-faire — economic theory. In both models as he put it, "the parties could be treated as individual economic units which, in theory, enjoyed complete mobility and freedom of decision." I suppose that laissez-faire economic theory comes down to something like this: If we all do exactly as we please, no doubt everything will work out for the best. Which does seem to be about the same thing that the contract theory comes down to, with liability reduced to a minimum and sanctions for breach cut back to the vanishing point. . . .
>
> It seems apparent to the twentieth century mind, as perhaps it did not the nineteenth century mind, that a system in which everybody is invited to do his own thing, at whatever cost to his neighbor, must work ultimately to the benefit of the rich and powerful, who are in a position to look after themselves and to act, so to say, as their own self-insurers.

Id.

I am not suggesting then that the Maryland legislators who voted for the statute lacked meaningful relationships with women, (or as Baier argues concerning ethicists, that contractarians must have lacked the sensitivity brought to them, typically by women, that contractarian models of ethics have shortcomings that trust models provide for). Instead, I join Baier and Gilmore in arguing that the contractarian model ignores the disparity in parties bargaining positions.

62. *See supra* note 19 and acompanying text.

the levels of loyalty expected from corporate managers have been too high and have had an overwhelmingly negative effect on the manager-shareholder relationship.[63] There are too many lawsuits and the loyalty standard is too uncertain for courts to deal efficiently with questions concerning the manager's behavior. Contractarians argue that under the old model, managers are spending too much time protecting themselves from lawsuits, rather than exercising their good faith business judgment in favor of shareholders.[64]

Yet trust theorists question whether the contractarians grasp the fact that the contractarian model will affect the manager's willingness to work for others. If the corporation is nothing more than a nexus of contracts, will management believe it has any obligation to act in favor of shareholders? The contractarian model is essentially a "trust us" and "you can't successfully sue us" position. Baier instead argues for a "trust first" but "sue later" model.

The implication of Baier's argument in the corporate setting is that the contractarian model does not inspire trust but, instead, moves the adversarial considerations from litigation, if it ever arises, to the beginning of the relationship. It also changes management's motivation to act for shareholders. By moving adversarial bargaining to the front of the relationship, greater distrust of both the manager and the shareholder will result. This distrust threatens the vitality and psychology of the relationship.

Whether the failure of the Maryland statute to comprehend the importance of trust in a corporate relationship is a result of male thinking or not, Baier's critique of contractarian models of decisionmaking is a sound one in the corporate context. Any statute that makes under-inclusive assumptions about the nature of the parties who are covered by it is shortsighted. Any statute that encourages members to distrust each other where they would otherwise trust each other is wrongheaded, whether written by men or by women. Baier and Gilligan's point is an interesting caution to those who propose contract solutions as a salvation of ethical dilemmas.

VII. CONCLUSION

Maryland is not alone in its adoption of a contract model of corporate governance. Georgia, Nevada, New Mexico, New York, North Carolina, Pennsylvania, Washington, and Virginia have done away with loyalty language in favor of contracting language as the basis of obligations regarding managers' conduct.[65] The emerging contract model ig-

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63. *See* Easterbrook & Fischel, *supra* note 46; *see also* Garrett, *Attitudes on Corporate Democracy - A Critical Analysis*, 51 NW. U.L. REV. 310, 310-11 (1956).
64. *Id.*
65. Hanks, *supra* note 4, at 48; *see also* CAL. CORP. CODE § 309 (West 1977 & Supp. 1988); DEL. CODE ANN. tit. 8, § 141 (1983 & Supp. 1988); GA. CODE ANN. § 14-2-801 (1982 & Supp. 1988); NEV. REV. STAT. § 78-140 (1985); N.M. STAT. ANN.

nores two crucial realities of the corporate situation: 1) shareholders are unlikely to understand the nature of the bargain that is suggested to them by management, and 2) the necessity of encouraging a condusive atmosphere for a thriving relationship between management and shareholders. While many argue that people are inherently selfish and that the contractarian model forces each side to get their selfishness out on the table, that argument overlooks the fact that many relationships thrive when they are based on selfless rather than selfish motivations. Many professional managers understand that they are subject to ethical responsibilities arising from the status they hold in the relationship; they know they have "professional" obligations which define their responsibilities beyond the specific contract language. If the statute advises the manager to ignore professional obligations of loyalty and bargain adversarially from the beginning, it will rework the fundamental nature of the relationship among the parties, sacrificing the atmosphere of trust on the altar of contract.[66]

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§ 53-11-35(B) (Supp. 1988); N.Y. BUS. CORP. LAW § 717 (McKinney Supp. 1989); N.C. GEN. STAT. § 55-35 (1982); 15 PA. CONS. STAT. ANN. § 410 (Purdon Supp. 1988); VA. CODE ANN. § 13.1-870 (1986); WASH. REV. CODE ANN. § 23 A. 08.343 (Supp. 1989).

66. *Cf.* G. GILMORE, *supra* note 61, at 94. Gilmore seems to be describing the death of contract analysis but concludes with the question — "but who knows what unlikely resurrection the Easter-tide may bring?" *Id.* at 103. I believe that Eastertide has arrived and that contract analysis has been resurrected in the form of a law and economics theory as applied to corporations.